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Fool's Gold

> **"The word 'mania' emphasizes the irrationality; 'bubble' foreshadows the bursting."**
>
> **Manias, Panics and Crashes**
> **Charles Kindleberger, 1978**

Wall Street continues to revel in its dream of perpetual boom. Ignoring the recessionary clouds gathering over the economic landscape, the bulls gleefully discount a "golden scenario" of slow growth, high profits and low inflation stretching as far as the eye can see.

In this atmosphere, setbacks instantly are translated into good news. Have the politicians in Washington failed to deliver on their grandiose promises of a balanced budget? Not to worry – fiscal paralysis surely will force the Federal Reserve to cut interest rates even further and faster. Are corporate earnings faltering? No doubt they will improve when the economy rebounds later this year.

As always, Europe follows the financial fads manufactured on Wall Street. We can only note with amazement the recent performance of Daimler Benz shares, which soared on the company's announcement of a $4 billion loss in 1995. A loss of such magnitude is viewed by speculators as a certain sign the worst is over.

We hardly agree. The curtain is drawing to a close on the feeblest global recovery of the entire postwar era. In Europe, a sharp, unexpected downturn in 1995's final quarter could well mark the onset of the recession. In America, industrial output and consumer spending both are dead in the water. The stimulative effects of last year's bond-market rally – made possible by the massive intervention of foreign central banks – are wearing thin. Japan, meanwhile, remains mired in a deflationary rut.

Dollar assets have been the main beneficiary of this growing drift towards global recession. With Europe's economies widely seen as hamstrung by high wages, inflexible labor markets and bloated welfare states, investors and speculators alike now gravitate to the American markets, drawn by the same perceptions of U.S. economic strength that have so bedazzled Wall Street.

In this issue, we take a critical look at this supposed U.S. advantage, and at the structural differences that have produced such a radical economic divergence between America and Europe. Our conclusion: Both economies are suffering the ill effects of decades of overconsumption and underinvestment. In Europe, this imbalance has led to chronic high unemployment. In the United States, it can be seen in stagnant wages and consumer incomes.

While we share the general scorn for Europe's welfare excesses, we do not think the U.S. alternative is necessarily superior. Europe's saving grace is generally rapid productivity growth, spurred by high wages. America's great weaknesses are persistently sluggish productivity growth, minimal wage gains, and an unsustainable buildup of consumer debt.

Europe's woes are obvious to all; America's still are obscured by bullish optimism. But as economic conditions deteriorate, we think the steady progression of grim headlines finally will force investors to face reality.

GROWTH PAUSE OR RECESSION?

The more downbeat the outlook for economic growth, the more upbeat the world financial markets. Since the announcement of an unexpectedly sharp weakening of the German economy, associated with a surge in unemployment to 9.9% in December, a burst of interest-rate fever has swept the European bond markets. The president of the Bundesbank himself added fuel to the fire by predicting further German rate cuts to come. Stock markets duly followed bond markets. Remarkably, German stocks did best among the major markets, with the DAX Index hitting new historic highs. Clearly, it's still a case of unmitigated complacency all around.

The reason for this complete lack of concern is easy to see. In general, it is taken for granted that the economic slowdown now spreading through both the United States and Europe is just a pause within a healthy long-term expansion. Though most economic indicators are still pointing downward, it remains a foregone conclusion among the consensus crowd that the industrial economies will rebound later this year.

Policymakers and analysts alike take comfort from the continuing decline in inflation rates, general wage moderation, and the steep decline in bond yields. Many also are gladdened by the fact that the customary precursors of a recession – rising inflation, monetary tightening and financial bear markets – appear to be absent.

Obviously, the graveness of the present economic slowdown is the key issue for 1996. Is this just a brief "growth pause," an extended period of weakness, or the start of a full-blown recession? This is the central question.

On the face of it, the slowdown appears very modest. The latest OECD economic outlook, published in December, estimates that real GDP in the industrial countries totalled 2.5% in 1995, ¼% less than projected last June and around ½% less than forecast at the end of 1994.

These differences between earlier forecasts and the actual result may seem hardly worth mentioning. But what the figures conceal is that the slowdown was concentrated in the second half of 1995, and particularly in the last quarter.

EURO-GLOOM VERSUS U.S. EUPHORIA

Another trend that strikes us as one of greatest importance is the vast difference in the prevailing perception of conditions in the United States and in Europe. Suddenly, there is nothing but doom and gloom about the ailing European economies, compared to near euphoria about the U.S. economy, which supposedly is experiencing a virtual renaissance in productivity growth and international competitiveness, thanks to wage moderation, booming investment in computers and other types of producers' durable equipment, and widespread corporate downsizing.

A good example of this kind of thinking appeared in the October 16, 1995 edition of *Business Week* magazine, which carried a lead article under the heading: "America's New Productivity – Technology is transforming the American economy into the most productive and competitive in the world. All this ferocious activity is part of a comeback that borders on reincarnation. It's a catch phrase for this era, the Age of Productivity. Can other nations follow America's example? Read on . . ."

Poor Europe. How can she hope to compete with such a juggernaut? Of course, prophesying the demise of Europe's economy as a consequence of its welfare-state excesses is an old pastime of economists. The well-known story is that European economies and labor markets are obstructed by too many regulations and rigidities, and that subsidies, wages, social payments and taxes all are too high. European vacations are too long – between 4-6 weeks annually – while European technology increasingly is falling behind that of the United States. Above all, Europe's growing army of unemployed is for many observers the most conspicuous emblem

Global Capital Market Trends

Equities
Selected Markets, % Change

Country (January 26)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	2.1%	2.3%	21.8%	-0.9%	23.6%
Canada	4.0%	4.0%	19.9%	0.0%	22.8%
France	5.4%	5.1%	7.7%	-2.5%	14.3%
Germany	6.3%	7.9%	19.8%	-0.4%	27.3%
Hong Kong	11.9%	10.3%	52.0%	0.0%	52.3%
Japan	3.8%	4.0%	14.3%	-0.0%	42.7%
Mexico	9.0%	10.8%	52.5%	-0.3%	112.7%
Spain	2.4%	2.5%	22.3%	-0.9%	29.9%
U.K.	2.1%	1.2%	24.2%	-0.6%	25.5%
U.S.	1.2%	0.9%	32.7%	-0.0%	32.7%

Ten-Year Bond Yields
Selected Markets, Basis Point Change

Country (January 26)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	8.01	-32	-26	-222	-239	0
Canada	7.11	-11	3	-225	-225	13
France	6.39	-27	-25	-171	-191	12
Germany	5.90	-18	-13	-155	-157	10
Japan	3.12	13	5	-154	-155	52
Spain	9.63	-14	-7	-215	-293	36
U.K.	7.44	-8	3	-119	-136	20
U.S.	5.64	-5	6	-211	-211	11

Exchange Rates
Versus U.S. Dollar, % Change

Country (January 26)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.36	-0.6%	-0.8%	-3.9%	-4.5%	3.8%
Canada ($)	1.38	-1.6%	-1.5%	2.4%	-3.9%	2.7%
France (*f*)	5.14	-4.6%	-5.1%	2.3%	-7.9%	3.4%
Germany (DM)	1.49	-4.1%	-3.7%	1.8%	-10.1%	3.1%
Japan (¥)	106.60	-4.2%	-3.0%	-7.2%	-32.2%	0.5%
Spain (Pt)	126.29	-4.0%	-4.0%	4.3%	-6.9%	5.0%
U.K. (£)	1.50	-3.6%	-3.2%	-5.5%	-8.3%	0.0%

of these excesses and fetters, which are strangling economic growth.

In contrast to this black-and-white exposition, we always have held the view that economic growth is dangerously ill-structured both in the United States and in Europe. The common denominator is massive capital consumption at the expense of productive investment.

EUROPE'S MALAISE

Yet there is a crucial, fundamental difference. Europe's economic malaise is entirely rooted in governmental fiscal excesses associated with inordinate wage rises and inflexible labor laws.

In the United States, by contrast, the primary cause of the capital shortage that is depressing investment and productivity growth is the extremely low savings rate. The federal budget deficit is a secondary factor.

At a bare 4%, the U.S. personal savings ratio compares with an average ratio in Europe of about 11-12%. The U.S. government's deficit as a share of GDP, on the other hand, currently is the smallest of any industrialized country. America also has the lowest tax burden.

Comparing the economic development of the United States and Europe over the last two or three decades, two major differences leap to the eye. The U.S. economy, while outstanding in creating jobs, has had the lousiest productivity performance of any industrialized country. Europe, by contrast, has had a disastrous employment record but superior productivity performance.

Considering the remarkable persistence of this divergence, there must be an essential, discernible cause. What is it? Before we answer the question, let's examine the relevant differences in economic performance: first, the rise in real income per employed person, which reflects largely the difference in productivity growth; secondly, employment growth; and thirdly, unemployment rates.

What we see are two fundamentally different patterns of economic growth. Growth in the U.S. economy tends to have a very high employment component but an unusually low productivity component. European growth shows exactly the opposite pattern: Minimal employment creation is coupled with strong increases in labor productivity.

Or, to put it differently, U.S. economic growth is labor intensive. Virtually by definition, this implies overproportionate employment creation in low-skilled, low-productivity activities, and in part-time work. European economic growth, on the other hand, is capital intensive, and concentrated in high-productivity activities involving very little job creation. What causes this difference?

In the first place, it can't be said that one pattern is superior or preferable to the other. It depends on the specific conditions of labor and capital supply in a given country. The labor-intensive growth of the U.S. economy perfectly fits the underlying conditions: strong population and labor-force growth, combined with very poor savings.

In the same vein, Europe's trend towards capital-intensive growth, combined with low job creation, has been in line with its poor demographics and high savings. The trouble is that in recent years the adjustment process has gone to extremes on both sides of the Atlantic, leading to unsustainable trends.

Real GDP Per Employed Person
(Annual Percentage Change)

Period	Euro 15	United States	Germany
1961-70	4.6%	1.9%	4.2%
1971-80	2.7%	0.6%	2.6%
1981-90	1.9%	0.8%	1.7%

Employment Growth
(Annual Percentage Change)

Period	Euro 15	United States	Germany
1961-70	0.2%	1.9%	0.2%
1971-80	0.3%	2.0%	0.2%
1981-90	0.5%	1.9%	0.5%

Unemployment Rates
(Percentage of Civilian Labor Force)

Period	Euro 15	United States	Germany*
1961-70	2.2%	4.7%	0.7%
1971-80	4.0%	6.4%	2.2%
1981-90	8.9%	7.1%	6.0%
1991	8.1%	6.7%	4.2%
1992	9.0%	7.4%	7.8%
1993	10.6%	6.8%	8.9%
1994	11.1%	6.1%	9.6%
1995	12.0%	5.7%	9.9%

*includes former East Germany after 1991

Source: European Commission and Deutsche Bundesbank

EUROPE: NOW IT'S MASSIVE JOB DESTRUCTION

In the case of Europe, we distinguish between two phases. The bottom table above shows a clear staircase-like pattern in the unemployment rate, which increased from 2.6% in 1971 to 8.4% in 1989. Employment continued to rise, though lagging even the modest growth of the European labor force.

The disastrous new feature of the Europe of the 1990s is that the insufficient employment creation of the past has given way to massive job destruction. Over the three years 1992-94, employment in the European Union declined by a cumulative 3.9%, as 5.8 million jobs were lost. Corporate Europe embarked on a course of heavy labor shedding, resulting in extraordinary productivity and profit improvements, while radically restraining their domestic investments. At long last, the welfare state and its associated wage excesses have boomeranged with a vengeance. After more than two years of economic recovery, Germany's unemployment rate is close to 10% - and rising.

By bidding the dollar higher, currency traders obviously are discounting even greater difficulties in Germany and Europe, and consequential rate cuts by the Bundesbank and other European central banks. It is the one thing upon which the markets presently focus.

The fly in the ointment is the slowdown of the U.S. economy. By the new chain-weighted measure, U.S. real GDP growth slumped from 3.5% in 1994 to 1.9% at an annual rate during the first three quarters of 1995. This compares with a consensus forecast of 3.1%. The decisive reduction occurred in investment in producers' durable equipment. While this has confounded most observers, it has fueled financial speculation rather than concern about recession.

Investment in Producers' Durable Equipment

(Percentage Change at Annual Rates)

	1992	1993	1994	1995/Q1	1995/Q2	1995/Q3
Revised	6.2%	10%	13.2%	15.3%	3.6%	5.3%
Previous	6.0%	18%	17.6%	21.5%	11.3%	8.3%

Source: Department of Commerce

If there is little belief in the possibility of a full-blown recession in Europe, there is utter disbelief that it might happen in the United States. To many, if not most, financial analysts, the U.S. economy appears to be enjoying a virtual golden age, with low inflation, huge wealth creation in the booming financial markets, and unusually strong capital spending. In Wall Street's judgement, the present U.S. recovery stands out from its postwar predecessors as being particularly well-balanced and healthy.

We hold precisely the opposite view. The current U.S. economic recovery has been both unusually feeble and extremely imbalanced. The one big imbalance is the huge, chronic trade deficit, and the other is the truly disastrous state of consumer finances.

ANYTHING IN EXCESS IS BAD

Wage moderation and labor shedding are good things until they go to extremes. That seems to be happening in the United States. One outstanding feature of this economic recovery has been its extraordinary deficiency in generating consumer income. Over the past 14 quarters, real disposable personal income in the United States has risen at an average annual rate of only 2.5%, the weakest recovery on record and barely half the 4.9% gain of the typical cycle. Essentially, such a drastic income shortfall implies continuous heavy borrowing to maintain consumer spending.

For good reasons, consumer finances have come under critical scrutiny lately. But most articles and reports that we read attempt to rationalize away the problem by seeking to prove that debt worries are overblown. The bulls have two favorite arguments:

- The soaring growth in debt is largely illusory because it has been more than offset in recent years by wealth gains arising from the prolonged boom in bond and stock prices. In this respect, 1995 was a banner year, with a record increase in household wealth of about $3 trillion, as against simultaneous debt growth of $351.6 billion.

- Aggregate debt, though rising relentlessly, is immaterial. Far more important is the debt-service burden, consisting of interest and principal payments on consumer installment and mortgage debt. While also rising quickly, debt-service payments, relative to disposable income, still are below their all-time high, set in 1989.

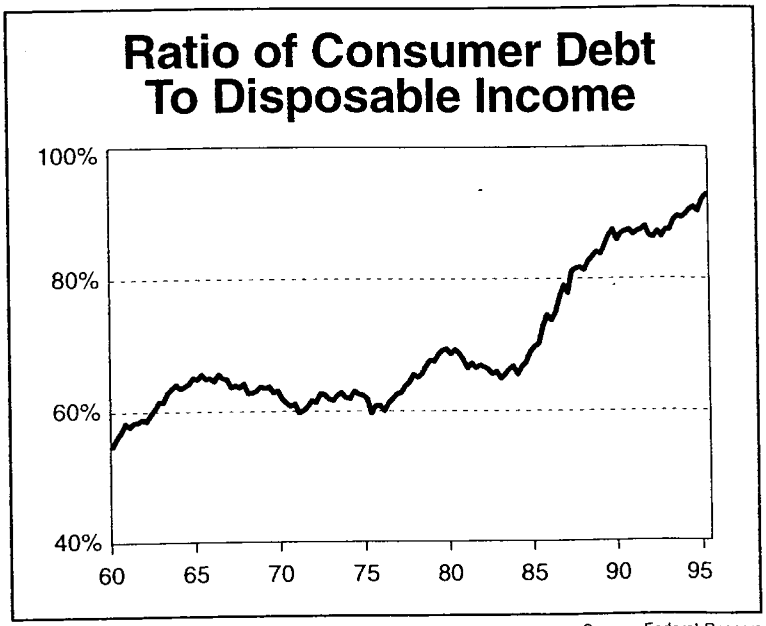
We don't want to waste too many words on a detailed rebuttal of these arguments. It's just too stupid. Yet we should make two brief points. Regarding the first argument – that the wealth effects of booming financial markets outweigh the rapid accumulation of debt – we doubt the big borrowers are identical to the big beneficiaries of the financial boom. Therefore, this raw comparison of general debt growth with general wealth gains is ludicrous.

Secondly, the fact that U.S. consumers were able to boost their total indebtedness over the past two or three years while adding little or nothing to their debt-service burdens had two temporary reasons. One was the long and steep decline in interest rates; the other was the fact that consumers managed to steadily decrease

their repayment of principal. This component of debt service now is at an all-time low. We think both games are nearly over.

To us, the decisive point about U.S. consumer finance is that it clearly is a Ponzi scheme, meaning that interest payments are being met by more and more borrowing. This simply cannot go on to infinity.

Jean Baptist Say, the father of supply-side economics, warned about this kind of debt financing: "It is impossible to avoid a precipice," he wrote, "when one follows a path that leads nowhere else."



Source: Federal Reserve

A WARNING SIGNAL

In our view, the most striking single sign of impending trouble for the U.S. economy is the fact that real retail sales, accounting for about 28% of U.S. GDP, have been flat since the fourth quarter of 1994, despite the continuing consumer-borrowing spree.

What is generally overlooked in this debate is that consumer borrowing, just like governmental borrowing, must grow continuously in order to maintain its expansionary thrust on the economy. If it merely stands still – or even worse, contracts – that is enough to instantly stop the music and curtail consumer spending.

That's exactly what happened in 1995. While consumer borrowing set new records in terms of the debt-to-income ratio, consumer spending was squeezed simply because borrowing slowed down from its previous torrid pace. A few figures may illustrate this important point:

During 1991-94, annual consumer borrowing skyrocketed from $182.7 billion to $360 billion, hitting a peak of $419 billion at an annual rate in the fourth quarter of 1994. This compared with an increase in personal disposable income of only $270.9 billion. That is, the amount that consumers borrowed was 33% in excess of their total income growth. What makes this debt excess even more frightening is that it occurred against the backdrop of only a modest rise in residential building and home sales.

In 1995, consumer-debt growth continued at an annual rate of about $350 billion. Considering this amount was still well in excess of personal-income growth, which also weakened, it hardly qualified as genuine financial retrenchment. Yet the mere fact borrowing failed to grow pulled the rug from under the consumer-spending boom.

Wall Street economists are never at a loss to make a bull story out of any economic malaise. We recently came across a report from one leading brokerage house that described it this way: Hard-pressed consumers are doing almost anything within their power to sustain long-standing spending habits. On the one hand, they refinance their existing debt at today's bargain-basement interest rates; on the other hand, lower income growth keeps them under intense pressure to shift their portfolios away from deposit accounts and towards securities offering higher yields or substantial capital gains. The happy result: Huge capital gains that vastly offset any rise in debt. From this, the author concludes that the consumer-borrowing boom, and the financial boom, have considerable staying power.

In other words: It's bullish economics to keep the consumer short of income. Not only does it improve business profits, it also forces him to seek compensation by forsaking his liquidity for higher-yielding bonds or for stocks that promise big capital gains. The bulls can truthfully say that consumers still have about $3 trillion in bank deposits and money-market mutual funds, just waiting to be put to work in the stock and bond markets.

THE PARTY ISN'T OVER YET

We have no doubt this liquidity play can go further. As we said in our last letter, the slowing of the U.S. economy, implying further rate cuts from the Federal Reserve, is bound to add fuel to financial speculation. And in fact, the speculators have embarked on a new rampage.

Money and liquidity are no obstacles. Through a host of devices, today's financial systems – particularly those in the United States – can literally produce unlimited amounts of money for speculation. For example, the cheap yen, costing less than 0.5%, presently is a prime source of the borrowed money fueling rampant global bond speculation. With nothing but further monetary easing in prospect around the world, it is hard to say what will stop this mania.

While we expected this new frenzied wave of speculation, we do not at all share the underlying euphoria about the economic prospects for 1996. The bulls love economic weakness because it is regarded as warranting low inflation, low interest rates and easy money as far as the eye can see – the ideal conditions for financial speculation. Still, there is a snag. What the bulls really want and are looking for is *contained* economic weakness, which would hold the expansion to its potential growth path in the major industrial economies.

For us, the key question is the probability of recession in Europe and the United States. Our disagreement with the complacent consensus begins with our assessment of monetary policy and the buoyancy of the financial markets.

The consensus takes great comfort from the belief that the sharp fall of long-term interest rates, and the associated wealth effects of booming stock and bond prices, plus further monetary easing in both Europe and the United States, will inevitably prevent recession and give rise to renewed stronger economic growth.

Everything has two sides. We think any investigation of the economic situation should start with two questions:

- Why has this world economic recovery been so unusually feeble in both the United States and Europe?
- Why have the economies slowed so sharply, despite extremely favorable financial conditions?

The financial markets may view subpar growth as the harbinger of low inflation and monetary ease, but it also reflects the steady, structural deterioration of the real economies. The overperformance of the financial markets disguises the relentless demise of long-term economic growth. This is true for America no less than for Europe.

We don't have ready answers for the questions we have posed. But they give reason to worry. In particular, they lead to another question, one the consensus completely shuns: Given the pronounced structural weakness of the real economies, why shouldn't the prevailing downturn accelerate, dragging many countries into full-blown recessions?

In Europe's case, it is easy to say what ought to be done to stop and reverse the rise in mass unemployment. But it's just as easy to predict that Europe's political class will not take those steps. To do so would imply a revolution in wage policy and in the bloated and overextended welfare system.

As we explained earlier, the growth pattern in Europe has had a high productivity component at the expense of employment growth. This pattern is determined by wage policies and structures, in conjunction with rigid labor laws and welfare excesses that exacerbate the job-destroying impact of the wage follies.

EUROPE'S WELFARE AND WAGE EXCESSES

The crucial point to see is that the European economies have been geared to persistent strong wage rises, coupled with a leveling of wage differentials between skilled and unskilled workers. As a result, low-skilled, low-productivity activities and part-time jobs, which have proliferated in the United States, have in Europe been priced out of the markets. Employment is only profitable in combination with heavy use of labor-saving machinery. In this way, strong wage rises actually produce and extend productivity gains, which in turn make possible high wage increases.

Wherever wage moderation has been exercised in Europe, it has had prompt, positive effects on employment. However, job creation with low productivity essentially diminishes average productivity growth and thus undermines the high wage demands to which European workers are accustomed.

Among the experts in Europe, the necessary, corrective remedies for rising unemployment are well-known. Prolonged, general wage moderation is required, together with a widening of wage scales to allow for the creation of more low-skilled and low-productivity jobs. Yet the politicians are flatly opposed. Here is what the European Commission had to say on the subject in its Annual Economic Report for 1995:

"In order to reach its target, a downward widening of the wage scale would imply a fall in the wage cost of low-skilled activities by about 20-30%, as happened, for instance, in the United States. Furthermore, in order to be efficient, the downward extension of the wage distribution in Europe would require a lowering of unemployment compensations and social protection schemes. This would create larger inequality and create 'working poor' groups. This would be just as damaging as unemployment for the social fabric. Finally, if the spirit of the European social model is to be kept, compensatory measures would have to be taken (e.g. negative income taxes for the lowest income groups) implying other kinds of social transfers."

Thus, the commission ends up with a sweeping rejection of wage reduction, on the grounds that the necessary government wage subsidies would burden the public purse just as much as unemployment compensation does now!

The salient point to realize is that European governments are loath to attack the unemployment problem at its roots – the welfare state and wage excesses. For the time being, we see no more than tinkering with the symptoms of the disease, rather than its cause. Quite typical in this regard, German trade unions and the government now demand the abolishment of overtime in order to create higher numbers of jobs.

In this light, the only conclusion we can reasonably draw is that unemployment in Europe will keep rising, and probably at an accelerating pace. It may reach quite dramatic heights if the European economies fail to recover later this year from their present sluggishness. But with the German repo rate already at 3.55%, there is little room for lower interest rates in Germany and Europe. In any case, we suspect that the prolonged economic weakness has other than monetary reasons.

THE U.S. MALAISE: RECORD DEBT AND LAGGING INCOME GROWTH

Rather more dissent probably will meet our following critical review of the economic situation in the United States. As we mentioned earlier, there is widespread euphoria about America's recent excellent performance in terms of technology, efficiency, employment, and international competitiveness in just about everything.

In the light cast by the old GDP statistics, it indeed looked as if there had been a breakthrough in capital spending and corresponding productivity growth. The plausible reasons generally cited were sharply increased use of computers and computer-related equipment, stronger investment in new plant and industrial machinery, and widespread corporate downsizing and labor-shedding.

Well, the breakthrough appeared real – until the middle of last year, when the Bureau of Labor Statistics published an extensive report on the drastic changes in the GDP and income accounts. As we explained in our last letter, the most striking effect of these new calculations was a substantial downward revision to productivity growth in the 1990s, reflecting mainly substantial downward revisions to real GDP growth and to capital spending.

Based on the new chain-weighted version of GDP, nonfarm business output has grown just 2.1% a year during the 1990s, vs. the 2.7% annual average previously reported. This statistical revision slashed average productivity growth to 1.2% per year, from the previous 1.8%. Though the shocking results of this revision have been known for months, economic and financial analysts, as well as the U.S. media, generally have ignored the unpleasant news.

It's not difficult to see why. It makes complete nonsense of Wall Street's story about the U.S. economic renaissance. But we think these rosy perceptions will change for the worse as weaker economic data shape the headlines.

The more interesting question is why the trends hailed on Wall Street haven't delivered the expected boost to U.S. productivity. In our last letter, we tried to give an answer. So it was with great interest that we read a study on the same subject recently published by the Federal Reserve Bank of Kansas City. Here, in short, are its conclusions:

- While the investment share of computers has nearly doubled since 1991, it still is too small, both in terms of current output and as a component of the existing capital stock, to significantly increase productivity. In fact, computers accounted in 1995 for just 3.1% of aggregate U.S. output and for only 2% of the U.S. capital stock.

- Excluding computer investment, the 1990-91 U.S. recession saw a sharp contraction in plant and equipment spending. After 1991, this investment component surged again. But excluding information-processing equipment, it still has not exceeded its historic trend.

- While downsizing and labor shedding hold out the promise of increased productivity, recent surveys indicate that in reality most downsized companies in the 1990s have not achieved the expected gains, despite higher profits. The Fed study links this failure to morale problems and organizational disruption following downsizing.

As we spelled out earlier, European economic growth, and job growth in particular, is obstructed by the welfare state and wage excesses. The U.S. economy today has the opposite distinction of being a low-wage economy among the industrial economies. But contrary to widespread opinion, this, too, is not automatically a token of economic health.

The clearest evidence of America's dilemma can be seen in the steady decline in average weekly real earnings since 1973. This reflects a progressive change in the entire output and employment structure of the U.S. economy towards lower-skilled, lower-paid and part-time jobs, associated with an equally strong shift away from long-term fixed investment to short-term equipment investment, mainly in computers. The Austrian school of economics had a name for this kind of adjustment process: They called it a shortening of the output structure.

The case against this growth pattern is that low wages and low productivity growth tend to become self-reinforcing, just as high wages are indissolubly linked to high-productivity growth in Europe. The people who envy America for its superior record of job creation obviously overlook the dark flip side: sinking living standards and pervasive job insecurity for a rapidly growing share of the American population.

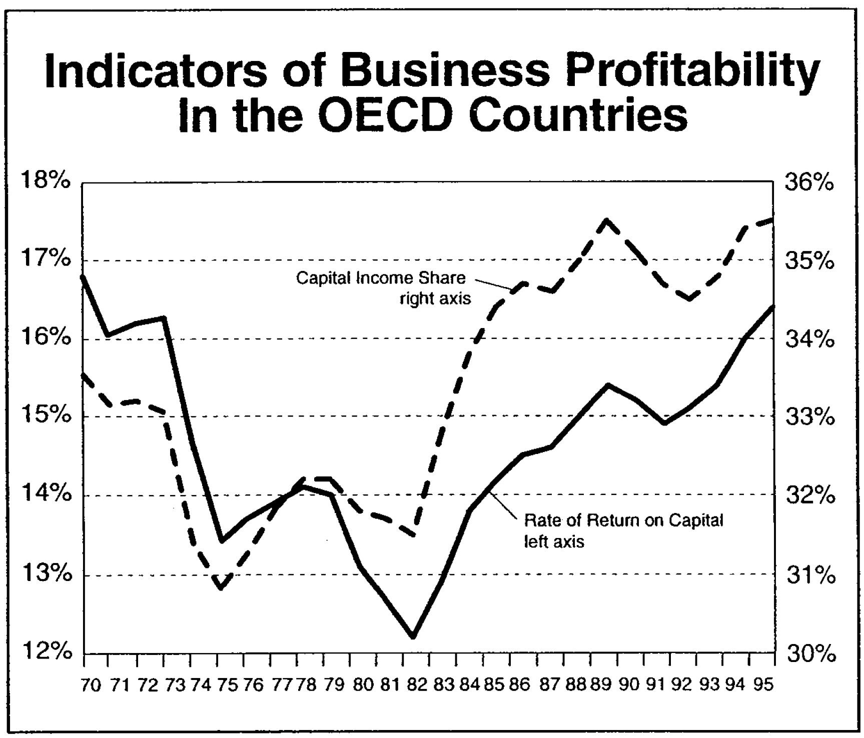
How does all this square with the high-technology boom? To sum it up, it's a question of relative quantity. In the popular perception of the U.S. economy, America's sweeping success in technology surely plays a dominant role. But as a share of total output and the capital stock, high technology is no more than the tip of the economic iceberg. The big areas of employment growth all have been in the low-productivity sectors.

ANOTHER ANOMALY: RECORD PROFITS, WEAK INVESTMENT

Wall Street is single-minded in its obsession with profit growth, from whatever source. Yet from a long-term perspective, how higher profits are achieved makes all the difference. The two alternative paths: a corporate growth pattern that boosts investment in plant and equipment, and the presently fashionable course of downsizing, which consists mainly of labor shedding, asset shuffling, mergers, etc.

There is no question but that downsizing has made many American corporations leaner and fitter. But the huge, chronic U.S. merchandise trade deficit signals unmistakably that Corporate America no longer has the capacity to meet the domestic demand for tradeable goods. Basically, downsizing is a clear-cut anti-growth strategy. It is anything but an emblem of economic health and dynamism.

Still, one positive thing is real: the profits bonanza. That trend, however, is not confined to the U.S. economy. Profit shares and rates of return in the OECD countries presently are the highest since the early 1970s, despite lower inflation rates. Unfortunately, high business profits have had an unusual, negative complement. Domestic fixed investment remains chronically weak almost everywhere.



Source OECD

In past times of healthy economic growth, a profits boom inevitably would have unleashed an investment boom. Producing those capital goods, in turn, would have boosted labor income and consumer spending. This is how strong-growth economies operate.

But businesses appear to have resigned themselves and adjusted to a long-run period of slow growth. Instead, they concentrate on the continuous improvement of profit margins through means other than expanding production.

Companies are flush with cash, equity prices are generous, and banks are falling over themselves to lend at abysmal margins, but even though market values are now nearly four times underlying book values, the big money still pours into acquisitions, usually with the intention of raising profits by firing redundant workers.

Investments in new plant, meanwhile, are financed from available cash flow and overwhelmingly are of the labor-saving kind. They also are associated with a strong drive to expand productive plants in the lower-wage countries. Again, this is true both for the United States and for Europe.

All this may look like a panacea for the financial markets, in particular for stock holders, by promising higher profits, low inflation and low interest rates forever. But the actual result is a definite, progressive demise of the real economies and the living standards of the people. In the long run, in our view, this road must lead into a depression.

The other critical point in this setting is the final impact of extensive labor shedding and wage cuts on the demand side of the economy. Essentially, the "fallacy of composition" that one frequently encounters in economics comes into play. Individual businesses may bolster their profits in this way. But when it becomes the common, universal practice, it tends to become self-defeating. Job cuts lead to a reduction in consumer purchasing power, leading to more job cuts and further reductions in consumer purchasing power.

In the case of the United States, consumers have compensated for the wage gap by stampeding into debt, spending vastly in excess of their income growth. Anybody with any common sense should be able to see that borrowing at such a frantic rate is not sustainable.

Can it go further? Of course it can. There is no absolute limit on how high debt levels can rise relative to income. Nevertheless, there are clues that the situation is rapidly worsening. One sign is that consumer borrowing sharply flattened in 1995, even though aggregate debt remained at a very high level. Certainly, it was not restraint by the banks that caused this slowdown. While debts continue to soar in relation to income, the ploy of trimming debt-service costs by prolonging the repayment of principal largely has been exhausted.

As we previously noted, debt growth requires permanent acceleration just to achieve the same degree of economic stimulation. With job creation slowing, and wage gains capped by downsizing, the truly critical point for the economy is fast approaching.

FACTS VERSUS BULLISH PERCEPTIONS

As we have repeatedly stressed, we listen carefully to all the bull stories. Yet at the same time, we always check the flows of funds in order to single out the true forces driving the markets.

In the lore of the markets, the Wall Street boom in stocks has been driven by excellent fundamentals and heavy individual buying through mutual funds. But, as we have pointed out in past letters, it is patently clear from the available data that the big buyers of U.S. stocks, and therefore also the key driving force behind the market's extraordinary bull run, have been the corporations themselves through their furious acquisitions, mergers and buy-backs.

Another example: The boom in U.S. bonds. According to Wall Street lore, it has been driven mainly by declining inflation and the prospect of sharply lower budget deficits, triggering a run by investors into fixed-income securities. This conveniently ignores the steep rise in private-sector borrowing, both corporate and personal, which is hitting near-record levels.

Still more intriguing is the role of foreign central banks. Treasury bonds held in custody for them by the Federal Reserve have jumped almost $100 billion over the past 12 months, boosting their total holdings to well over $500 billion. Without a doubt, these purchases have made foreign central banks – not private investors – the most decisive bullish influence on the market.

The very same question arises in relation to the dollar and its behavior in the currency markets. How strong is the dollar, really, if it permanently requires such heavy support from foreign central banks?

Clearly, the event that kicked off the dollar's recent rally was news of the sudden, sharp weakening of the German economy, which took the markets by surprise and forced the European central banks to cut interest rates. Worse, this picture of seriously ailing German and European economies contrasts with the prevailing euphoria about the health of the U.S. economy.

Another important influence on the currency markets has been the ups and downs of the prospects for European Monetary Union. Expectations that it will materialize have caused many investors to dump low-yielding DM instruments and buy high-yielding bonds denominated in Italian lira, Spanish pesetas and Swedish kroner. This is depressing the mark against all major currencies, but particularly against the dollar, since the EMU-related trades often require investors to sell marks for dollars and then sell the dollars for lira, pesetas and kroner.

In addition, we note a concerted U.S.-European effort to talk the dollar up against the mark. While this has rarely worked in the past, the markets this time are latching on to anything that might give the dollar a boost.

CONCLUSIONS

We have no doubts that the complacency regarding the U.S. economy's health and strength, and the current high tide of EMU speculation, both will come to a dead end. Near-term, the wild card is whether the U.S. economy will show even more evidence of pronounced weakness, leading the Fed to more aggressive easing.

Sluggish economic growth has become the dominant issue across the industrialized world, implying further rate cuts all around. Recent U.S. economic data are fragmentary and distorted, but it seems plain that the economy no longer has a single major area of strength. Despite the booming financial markets, reflecting extremely loose money, all the major demand components have been losing momentum.

Of course, economic weakness tends to be good for bonds, but considering the preceding stampede into bonds, one has to wonder to what extent future rate cuts have already been discounted by the market. In any event, unexpected economic weakness would spell trouble for the stock markets.

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